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RUEHBR/AMEMBASSY BRASILIA 0409
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RUEHMN/AMEMBASSY MONTEVIDEO 4027
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SUBJECT: FEDERAL RESERVE BOARD GOVERNOR KROSZNER A HIT IN CHILE

11. (SBU) SUMMARY: Federal Reserve Board Governor Randall Kroszner presented the keynote address at a Central Bank-hosted conference for representatives of the banking and financial sector in Santiago on August 29. In his first visit to Chile, Kroszner also met with influential business entrepreneurs, academics, financial experts, and current and former Central Bank and government ministers. While discussions often focused on the state of the U.S. economy, Governor Kroszner also spoke about the challenges facing the U.S. financial system, risk management, and the effects of the housing and sub prime crisis. His Chilean interlocutors expressed their concerns over increasing inflation, skyrocketing fuel costs, labor market inflexibility, and the need to improve education in Chile. END SUMMARY.

In High Demand

12. (U) During a packed five-day program (August 26-31), Federal Reserved Board Governor Randall Kroszner met with Central Bank President Jose De Gregorio, Codelco CEO Jose Pablo Arellano, Finance Minister Andres Velasco, Bank Superintendent Gustavo Arriagada, former Central Bank President Vittorio Corbo, and representatives from private banks and the banking association. At a luncheon hosted by the Ambassador, Kroszner discussed the global economy and Chile's performance with former Finance Minister Eduardo Aninat, University of Chile Economics and Business Dean Felipe Morande (also advisor to Presidential candidate Sebastian Pinera), Adolfo Ibanez University Rector Andres Benitez, former Finance Minister Carlos Caceres, and Celfin Capital brokerage board president Juan Andres Camus.

13. (U) Several institutions held events in Fed Governor Kroszner's honor. In addition to its conference, the Central Bank hosted two events, one with Central Bank Board Members and a second with financial sector regulators and key Central Bank managers. AmCham and Banco de Chile organized a dinner with influential private sector and bank representatives. A 16-year professor at the University of Chicago, Governor Kroszner attended a gathering with prominent Chilean Alumni and a private dinner with business magnate Alvaro Saieh (who has a PhD from the University of Chicago). The Fed Governor also visited the Santiago Stock Exchange and reviewed the salmon industry in southern Puerto Montt, the wine sector in central Casablanca valley, and El Teniente mine -- the world's largest underground copper mine -- near Rancagua, south of Santiago.

Central Bank: Pressure To Liberalize Energy Exploration

14. (SBU) In a courtesy call with Central Bank President Jose De Gregorio, Governor Kroszner expressed his thanks for the invitation to speak in Chile and the two discussed the upcoming central bank conference in Argentina. De Gregorio made reference to Chile's energy concerns, noting that there was increasing political pressure on the GOC to liberalize rules governing energy exploration. Normally, investors working with the government are required to use a process called "L600," which allows for contracts between the state and private companies. However, because of environmental sensitivities, oil drilling is excluded from the L600 process and requires special (and thus more complex and restrictive) documentation. However, as Chile's energy costs escalate, and efforts to diversify energy gather steam, there has been a push to make the process easier.

CODELCO: Copper Prices Will Stay High

15. (SBU) Governor Kroszner met with CEO Jose Pablo Arellano of the national, state-owned copper company, CODELCO. Arellano believed copper production would remain unable to respond to demand pressures in the near term, which augured for sustained high copper prices. He said despite current weakness in world demand, in 2007, copper production had fallen short of what was promised by 900,000 tons. Short-term capacity in copper production was limited but had been overestimated by many experts, leading in part to the dramatic increase in copper prices. In addition, changes made in supply (such as new mines, or increased productivity) were often associated with long lag times (up to 12 years in many cases). China had accounted for almost all of the demand expansion since 2002, and was an aggressive consumer of Chilean copper products. However, unlike in Africa, Chinese companies had not yet sought direct equity in copper producing companies in Chile.

Finance Minister Velasco: Econ 101

16. (SBU) Governor Kroszner's meeting with Finance Minister Andres Velasco was a reunion of two friends who were fellow academics. They grilled each other on the theories and models underlying current global macroeconomic trends (e.g., price model for oil). Ambassador Simons joined the banter, noting in the last five years, there had been no dramatic change in the global supply of oil in the ground, but prices had risen considerably. The main factors were an inability to solve political risks associated with supplies and an inelasticity of demand in countries such as China and India, where fuel is subsidized. Velasco noted the GOC had provided a cushion for consumers on fuel costs, but the price had increased 40% in the last month alone. Argentina had a contract to sell Chile 18 mcm of gas per day, but reneged, which the Ministry estimated cost Chile one percent of GDP per year for the last three years.

17. (SBU) Velasco noted Chile enjoyed a public surplus of almost seven percent of GDP. The Finance Ministry wanted to use the surplus to pay down remaining debts, but there was very little left. The Ministry had already recapitalized the Central Bank, which had acquired debt during the banking crisis of the 1980's. It was now examining repaying debt from Chile's transition to privatized pension funds.

18. (SBU) Velasco also explained the budget approval process in Chile was easier than in the U.S.: 1) Congress could not originate a bill for expenditure without the Ministry's sponsorship; 2) the Finance Ministry was required to submit the budget by September 30, but if a fully approved and amended budget was not passed by the Congress before November 30, the Ministry's original submission would automatically become law. Velasco added that Chile's Sovereign Wealth Funds' investment rules were quite conservative and easy to sell to Chile's strong export lobby, because they realized intense domestic investment risked exchange rate appreciation.

Former Central Banker: Next Team Will Do Better

19. (SBU) In an office call with Vittorio Corbo, an old friend and former Central Bank President, Kroszner exchanged opinions on the

global economy. Corbo also expanded on Chile's recent economic difficulties. He highlighted inflationary pressures and the 38% rise in energy costs over the last 12 months. He expressed relief there is consensus across the political spectrum on the need to curb inflation, which has increased to nearly 10 percent.

¶10. (SBU) Corbo praised Finance Minister Velasco for following sound fiscal policies. He noted that despite national elections in 2009, the GOC is planning to decrease fiscal spending from nearly 10% of GDP to around 6% over the next year. This runs counter to what many would expect prior to an electoral campaign. To help reduce inflation, interest rates are being increased gradually and could approach 10% by the end of 2008, he estimated.

¶11. (SBU) Corbo was critical of Minister of Labor Osvaldo Andrade, claiming he is pursuing policies that are akin to those in the 1950s and do not contribute to increased investment. The Minister has not promoted a labor regime that facilitates the hiring and firing of workers. Corbo argued that the high severance pay schemes, for example, needed to be eliminated, which would help increase salaries. The former Central Bank President indicated that the next government, whether headed by Sebastian Pinera or former President Lagos, would do a better job overall.

Chile's Economic Constraints

¶12. (SBU) The Ambassador hosted a lunch at the residence for Governor Kroszner on August 28 with top economists. While much of the conversation focused on the U.S. economy and international financial markets, the Chilean guests expressed several concerns about Chile's current path. Felipe Morande, a Pinera advisor, expressed alarm over inflationary pressures from excessive government spending, spiraling energy costs, and a lack of new GOC thinking.

¶13. (SBU) Eduardo Aninat identified energy, education, and the labor market as three crucial areas that hinder Chile's advancement in the world market. Fuel costs have skyrocketed because Chile has no independent source of energy and Argentina failed to abide by natural gas supply contracts. On education, he noted Chileans lack English language and technical skills necessary to excel in the modern work force. Aninat stated that the labor force needed to be more flexible, facilitating the hiring and firing of workers. Stock broker Juan Andres Camus agreed. He said that when investors examine whether to pursue a project, they need to know the costs of getting out. The costs associated with terminating employees are too high in Chile, he emphasized.

¶14. (SBU) Former Finance Minister Carlos Caseres lamented that Chile had lost an opportunity to take advantage of high commodity prices, in particular for copper. He noted that levels of productivity had decreased 3-4%, inflation is rising, and economic growth is slowing. He argued that the current government is generally pursuing successful public policies implemented in the past (i.e., from the Pinochet regime), but is not doing it out of conviction.

When EF Hutton Speaks...

¶15. (SBU) Comment: Chilean officials and members of the private sector expressed great appreciation for the opportunity to exchange views with Governor Kroszner. When he spoke about the state of the U.S. economy, the housing slowdown, and difficulties with financial securities, his Chilean interlocutors listened attentively. At the Ambassador's event, for example, one former Finance Minister took copious notes. The visit proved highly productive and helped reinforce the close bilateral relations we enjoy with GOC contacts and the private sector.

SIMONS